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California Supreme Court Allows Declaratory Relief and Bad Faith Claims to Proceed Against Excess Insurers Before Underlying Exhaustion

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KEY POINTS

- The California Supreme Court unanimously held in *Fox Paine & Company, LLC v. Twin City Fire Insurance Company* that insureds may seek declaratory relief against excess insurers before underlying insurance is exhausted, provided the loss is reasonably likely to reach the excess layer.
- An insured may also, under some circumstances, plead a bad faith claim against an excess insurer pre-exhaustion, but only if the insured alleges facts showing coverage will attach and that the insurer's misconduct impaired the insured's recovery of benefits owed under the policy.
- The ruling is expressly limited to the pleading stage; allegations of coverage and impairment must ultimately be proven to support a tortious bad faith recovery.
- Open questions remain, including the scope of excess insurers' duties before underlying exhaustion, to be resolved through future litigation.

On July 27, 2026, the California Supreme Court issued a significant opinion in *Fox Paine & Company, LLC v. Twin City Fire Insurance Company*, No. S287404, with important implications for excess insurers. In a unanimous decision authored by Chief Justice Guerrero, the court held that an insured may bring declaratory relief and, under some circumstances, bad faith claims against an excess insurer before underlying insurance is exhausted.

Following extensive underlying litigation, the insured in *Fox* filed a declaratory relief and bad faith action seeking coverage under a $50 million layered insurance tower consisting of a $10 million primary policy and four successive excess policies totaling $40 million. The insured named both the primary carrier and excess carriers, specifically alleging that the excess insurers improperly communicated with and paid millions of dollars to the third-party claimants, rather than the insured. The insured did not, however, allege exhaustion of the first layer excess policy, so the trial court sustained demurrers by the higher-layer excess carriers, and the Court of Appeal affirmed. (*Fox Paine & Co., LLC v. Liberty Mutual Ins. Co.* (2024) 104 Cal.App.5th 1034.)

After granting review, the California Supreme Court reversed and remanded, holding that an insured could sufficiently plead declaratory relief and bad faith against the excess carriers to defeat a demurrer despite no exhaustion of the underlying policy. The court held that an insured could seek declaratory relief against an excess insurer, before underlying exhaustion, so long as it is *reasonably likely* the insured's potential liability will reach into the excess coverage.

Perhaps the most controversial and potentially consequential portion of the decision is the court's finding that an insured may be able to plead a bad faith claim against an excess insurer even before the excess insurer's coverage has been triggered through exhaustion of the underlying insurance. The court recognized that "the absence of prior exhaustion means it cannot yet be said . . . that an excess insurer is in breach of any express promise within the policy to provide coverage upon the exhaustion of all underlying insurance." Nevertheless, the court went on to hold that under certain circumstances, an insured may still plead a bad faith claim against an excess insurer before exhaustion because "an insurer may breach the implied covenant of good faith and fair dealing while remaining in technical compliance with the express terms of its policy[.]" The court went on to say that "a breach of the implied covenant of good faith and fair dealing can occur before coverage is due and prior to the breach of any obligation to pay benefits under a policy[.]"

Policyholder counsel may attempt to argue that this language opens the door for bad faith claims to be brought against both primary and excess insurers even where the insurer has not disclaimed coverage or withheld any benefits due under the policy, and even where the policy does not afford coverage for the claim. This could lead to insureds claiming bad faith whenever they disagree with an insurer's actions, even when the insurer has accepted coverage and has not breached any duty owed to the insured. Such an interpretation, however, would be mistaken and takes the court's words out of context.

The court clearly limited its holding to situations at the pleading stage of a lawsuit where insureds (1) "allege facts that, taken as true, are sufficient to show that coverage under a defendant insurer's excess policy *will* attach" (italics in original), and (2) allege facts that, taken as true, show that "the insurer's misconduct has impaired the insured's recovery of benefits owed to it under the policy." An example of such impairment, provided by the court, is where it is "the insurer's bad faith itself that prevents an insured from fulfilling all of the conditions of coverage[.]"

Under the court's formulation, to state a claim for bad faith, an insured would still have to plead facts that would establish coverage under the policy — as the court said, the insured must allege facts that, if true, show coverage under the policy "*will* attach" and that the insurer impaired the insured's recovery of *benefits owed* under the policy. Accordingly, if the policy does not afford coverage, there can be no bad faith under the rule announced by the court. Indeed, the court acknowledged in footnote 12 that under its prior decision in *Waller*, the rule in California is, and remains, that there can be no bad faith in the absence of actual coverage. The court expressly declined to consider whether to make "an exception to the coverage requirement" in this decision, thereby confirming that the holding in the case does *not* create an exception to that rule.

It should also be noted that the court emphasized its holding was made in the context of a demurrer and that it was only addressing what an insured must allege to make it past the initial pleading stage. The court made clear that the "allegations must be proven for a plaintiff to *recover* for tortious bad faith, which may present its own challenges[.]" (Italics in original). This would include proving that (1) there was coverage, and (2) the insurer's conduct actually impaired the insured's recovery of benefits owed. If it is ultimately determined that the policy does not cover the claim, or if the insured's loss did not, in fact, exhaust the underlying insurance as required by the terms of the excess policy, this decision should not permit an insured to recover for bad faith.

The court's decision leaves some questions unanswered, for example, what may qualify as sufficient "impairment" to the recovery of benefits owed to give rise to a bad faith claim under this holding. Relatedly, and

more of concern, is whether or how this decision might be interpreted to enlarge the role and duties of excess insurers before the underlying insurance has been exhausted and coverage under their policies have been triggered. These questions will likely be answered through future litigation.

For more information about this decision and its implications for excess insurance coverage, please contact your Troutman Pepper Locke relationship attorney or a member of our Insurance + Reinsurance Practice Group.

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